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### Bad Faith Strictly Defined for Private Commodities Lawsuits: Sam Wong & Son, Inc. v. New York Mercantile Exchange

Joseph M. Barry

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# COMMENTS

## **BAD FAITH STRICTLY DEFINED FOR PRIVATE COMMODITIES LAWSUITS: SAM WONG & SON, INC. v. NEW YORK MERCANTILE EXCHANGE**

The Commodity Exchange Act (CEA)<sup>1</sup> provides the mecha-

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<sup>1</sup> 7 U.S.C. §§ 1-26 (1982) (originally enacted as the Grain Futures Act, ch. 369, §§ 1-12, 42 Stat. 998, 998-1003 (1922)). Congressional attempts to regulate commodities futures trading can be traced back to the Futures Trading Act of 1921, ch. 186, 42 Stat. 187. The Supreme Court, in *Hill v. Wallace*, 259 U.S. 44, 68 (1922), declared the Futures Trading Act unconstitutional because of a "burdensome" penalty tax on improper grain futures transactions. *Id.* at 66-67. Congress responded by enacting the Grain Futures Act, ch. 369, 42 Stat. 998 (1922), which was upheld as a valid exercise of the congressional commerce power. See *Chicago Bd. of Trade v. Olsen*, 262 U.S. 1, 37-38 (1923). The concept of self-regulation dominated the Act, and, consequently, exchanges were required to regulate trade to prevent price manipulation and other abuses. See S. REP. NO. 1131, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5843, 5855. Congress amended the Act, see *Commodities Exchange Act (CEA)*, ch. 545, 49 Stat. 1491 (1936), because it did not provide sufficient legal authority to enforce regulations against excessive speculation and other abusive practices, see Valdez, *Modernizing the Regulation of the Commodity Futures Markets*, 13 HARV. J. ON LEGIS. 35, 38 (1975). In 1968, extensive changes were made to the CEA, see Pub. L. No. 90-258, 82 Stat. 26 (1968), including an amendment requiring contract markets to enforce their rules, see *id.* § 12(c), 82 Stat. at 29 (codified at 7 U.S.C. § 7a (8)-(9) (1982)).

In 1974 Congress overhauled the CEA by enacting the *Commodities Futures Trading Commission Act*, Pub. L. No. 96-463, 88 Stat. 1389 (1974). The most significant effect of this legislation was the creation of the *Commodity Futures Trading Commission (CFTC)*, a new regulatory agency charged with implementing the CEA. See Valdez, *supra*, at 37. By giving the CFTC broad regulatory and enforcement powers, see generally *id.* at 44-51, Congress hoped to ensure "fair practice and honest dealing on the commodity exchanges," and prevent activities that would adversely affect commodities trading, see S. REP. NO. 1131, 93d Cong., 2d Sess. 1, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5843, 5844.

Finally, in 1982 Congress amended the CEA by expressly authorizing private rights of action on behalf of market participants against members of an exchange and other traders for certain violative activities. See Pub. L. No. 97-444, 96 Stat. 2294 (1983) (codified in scattered sections of 7 U.S.C. (1982)). See generally Sackheim, *Parameters of Express Private Rights of Action for Violations of the Commodity Exchange Act*, 28 ST. LOUIS U.L.J. 51, 53 (1984).

For excellent summaries of the legislative history of the CEA, and the purposes and weaknesses of its predecessors, see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 360-67 (1982); see also Rainbolt, *Regulating the Grain Gambler and His Suc-*

nism for regulating the complex and volatile world of commodities futures trading.<sup>2</sup> To regulate the industry strictly, section 4 of the CEA<sup>3</sup> mandates that all dealings in commodities futures must be transacted through an official board of trade called a "contract market."<sup>4</sup> The Commodities Futures Trading Commission

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cessors, 6 HOFSTRA L. REV. 1, 6-17 (1977) (discussion of commodities regulation in United States).

<sup>2</sup> See H.R. REP. NO. 975, 93d Cong., 2d Sess. 1 (1974). Section 3 of the CEA acknowledges the economic significance of commodities futures trading, warning that such transactions are subject to factors that may cause unexpected fluctuations in the price of commodities, and thereby obstruct and burden interstate commerce. See 7 U.S.C. § 5 (1982).

A commodity futures contract is an agreement for the purchase and sale of a particular commodity. See 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 4.6 (421) (1979). The seller commits himself to deliver the commodity at a fixed date in the future, while the buyer commits himself to accept the delivery and pay an agreed price. *Id.* These contracts are bought and sold to bidders in markets called "exchanges." *Id.* The terms of these contracts, except for price, are governed by the rules of the exchange. *Id.*; see also *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1156 (8th Cir. 1971) (trading in commodities futures must be conducted only in designated contract markets, in accordance with market rules), *cert. denied sub nom.*, 406 U.S. 932 (1972). Most futures contracts are not technically performed by traders; the contract holders redeem them by entering offsetting futures contracts in the exchange. See Clark, *Genealogy and Genetics of "Contract of Sale of a Commodity for Future Delivery" in the Commodity Exchange Act*, 27 EMORY L.J. 1175, 1176 (1978); see also *Leist v. Simplot*, 638 F.2d 283, 286 & n.2 (2d Cir. 1980) (few futures contracts actually result in delivery), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982).

A purchaser of futures contracts who is bound either to accept the commodity when tendered or make an offsetting sale is known as a "long" trader, while a trader who has sold futures contracts is known as a "short" trader. *Cargill*, 452 F.2d at 1156-57; see also S. REP. NO. 1131 3d Cong., 2d Sess. app IX, reprinted in 174 U.S. CODE CONG. & AD. NEWS 5891 5891-94 (glossary of key commodity terms).

Futures trading can be divided into two broad categories: hedging and speculating. See P. JOHNSON, COMMODITIES REGULATION § 1.11 (1982). Hedgers are producers and consumers of a particular commodity who, to protect themselves against adverse price fluctuations, acquire futures contracts that offset their normal commercial obligations. *Id.* § 1.12, at 38-39. For example, a merchandiser of a commodity who has an agreement to purchase that commodity at a fixed price may protect himself against falling prices of that commodity by acquiring futures contracts under which he is obligated to sell that commodity at a fixed price. *Id.* That merchandiser is said to have "hedged" against a price decrease. See Toy, *Implied Causes of Action Under the Commodity Exchange Act*, 14 COMM. L. REV. 41, 44 (1981). Speculators, on the other hand, do not have an interest in the actual commodity, but trade in futures contracts for investment purposes. See P. JOHNSON, *supra*, § 1.14, at 46.

<sup>3</sup> 7 U.S.C. § 4 (1982).

<sup>4</sup> *Id.* Section 4 prohibits dealings in commodity futures, except "where such contract is made by or through a member of a board of trade which has been designated by the [Commodity Futures Trading] Commission as a 'contract market.'" *Id.* These contract markets, also known as "futures exchanges," are nonprofit organizations that draft and enforce trade regulations, set quality standards for the commodity, and establish mechanisms for buyers and sellers. See Bianco, *The Mechanics of Futures Trading: Speculation and Manipulation*, 6 HOFSTRA L. REV. 27, 34 (1977). First established in the United States in the nine-

(CFTC)<sup>5</sup> is empowered to regulate commodities futures trading and is responsible for designating qualified boards of trade as contract markets.<sup>6</sup> Subject to approval by the CFTC, contract markets are empowered to develop and enforce bylaws and regulations<sup>7</sup> and may enact temporary rules to deal with emergency situations without CFTC approval.<sup>8</sup> A private party may maintain an action for damages only if the activity of a contract market is alleged to constitute a bad faith violation of the CEA.<sup>9</sup> Recently, in *Sam Wong*

teenth century, futures exchanges helped develop American agriculture into a stable and efficient commercial system by providing systems of communication to guide prices, marketing, and distribution of commodities. *Id.* at 27; S. REP. NO. 1131, 93d Cong., 2d Sess. 11, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5843, 5853. For a history of the development of commercial exchanges, see C. LEGG, THE LAW OF COMMERCIAL EXCHANGES 1-16 (1912). For a discussion of the requirements for designation of an exchange as a contract market, see *infra* note 6 and accompanying text.

<sup>5</sup> See 7 U.S.C. § 4a(1) (1982). The Commodities Futures Trading Commission (CFTC) was created as an independent agency of the United States government, see *id.*, "to strengthen the regulation of futures trading," Statement of Purpose, Pub. L. No. 93-463, 88 Stat. 1389 (1978). See generally Smith, *Preventing the Manipulation of Commodity Futures Markets: To Deliver or Not to Deliver*, 32 HASTINGS L.J. 1569, 1569-70 (1981) (to prevent manipulation of commodity prices, futures markets strictly regulated by CFTC).

<sup>6</sup> See 7 U.S.C. § 7 (1982). To be designated a "contract market," the board of trade must comply with certain requirements: the prospective contract market must be located at a terminal market where the commodity is sold in substantial volume, and where inspection facilities are located, *id.* § 7(a); the governing board of the market must provide for the keeping of detailed records of all transactions to be entered into by the members, *id.* § 7(b); and the board must provide for the prevention of price manipulation or cornering of any commodity by any dealers or operators on the governing board, *id.* § 7(d).

<sup>7</sup> *Id.* §§ 7a(1), (8) (1982).

<sup>8</sup> *Id.* § 7a(12). The rules of the CFTC define an "emergency" as, *inter alia*,

(ii) an occurrence or circumstance which, in the opinion of the governing board of the contract market, requires immediate action and threatens . . . fair and orderly trading in . . . any contract for the future delivery of a commodity or any commodity option on such contract market. Occurrences and circumstances which may [constitute] emergencies include . . . :

(c) Any circumstances which may materially affect the performance of contracts or commodity options traded on the contract market.

17 C.F.R. § 1.41(a)(4)(ii)(1984). CFTC rules require contract markets to maintain surveillance of market activity for indications of situations that may cause price distortion. *Id.* § 1.51(a)(1).

<sup>9</sup> See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 388 (1982). *Curran* involved the consolidation of four lawsuits by investors that alleged violations of the CEA by the various defendants. *Id.* at 356. In one case, the plaintiff alleged that the defendant broker had violated the CEA by making "material misrepresentations" regarding commodity transactions made on the plaintiff's behalf. *Id.* at 368. The Court of Appeals for the Sixth Circuit made a *sua sponte* determination that a plaintiff could maintain a private action for damages under the CEA. *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216, 230 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982).

The other actions, which were in the Second Circuit consisted of three lawsuits by spec-

& Son, Inc. v. New York Mercantile Exchange,<sup>10</sup> the Court of Appeals for the Second Circuit held that a plaintiff who alleged that members of a contract market had acted in bad faith in taking emergency action stated a cause of action,<sup>11</sup> while another plaintiff, who merely alleged a failure on the part of the New York Mercantile Exchange to take timely emergency action concerning potato crop failures, did not present a sufficient complaint.<sup>12</sup>

In *Sam Wong*, a New York Mercantile Exchange (NYME or Exchange) Maine Round White Potato Futures Contract provided for the delivery of potatoes from Maine to Hunts Point, New York<sup>13</sup> during the standard delivery months of November, March, April, and May.<sup>14</sup> Of the fifty deliveries made in November 1978, fifteen failed to pass inspection at Hunts Point.<sup>15</sup> After a preliminary investigation<sup>16</sup> and continued monitoring of the situation

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ulators in futures contracts against the New York Mercantile Exchange, in which the plaintiffs alleged a failure on the part of the Exchange to prevent manipulation of the contract market by various traders. *Leist v. Simplot*, 638 F.2d 283, 289 (2d Cir. 1980), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982). The plaintiffs maintained that the Exchange could have prevented this manipulation if it had followed its rules and declared an emergency once the situation became apparent. *Id.* at 291. The Second Circuit, in an opinion by Judge Friendly, held that Congress was aware of previous judicial recognition of private lawsuits under the CEA, and impliedly preserved them in its 1974 Amendments to the CEA. *Id.* at 307.

The Supreme Court, in a five to four decision, affirmed the Second and Sixth Circuits, and held that the judicially created cause of action under the CEA had not been abolished by the 1974 amendments to the CEA. 456 U.S. at 388. For a discussion of the development of the private cause of action under the CEA, see *infra* notes 39-50 and accompanying text.

<sup>10</sup> 735 F.2d 653 (2d Cir. 1984).

<sup>11</sup> *Id.* at 678.

<sup>12</sup> *Id.* at 666, 670-71.

<sup>13</sup> *Id.* at 657. Each Maine Round White Potato Futures Contract consisted of 50,000 pounds of potatoes delivered in a single truckload shipment. *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 658. The NYME potato contract mandated two inspections for each delivery, the first by a federally authorized state inspector in Maine, and the second by a federal inspector at the final destination, Hunts Point. *Id.* at 657. Each truckload of potatoes delivered had to receive the U.S. No. 1 grade, as established by the United States Secretary of Agriculture. *Id.*

All fifty deliveries passed inspection upon departure from Maine. *Id.* at 658. At Hunts Point, eleven of the fifteen loads failed because of apparent deterioration in transport from Maine. *Id.* These potatoes were highly pitted and discolored, which precluded their designation as U.S. No. 1 grade. *Id.* The other four truckloads, it was determined, should have been rejected in Maine for similar qualitative failures. *Id.*

<sup>16</sup> *Id.* In late November, the Exchange Potato Control Subcommittee reviewed the results of the November deliveries, and tentatively concluded that there were no foreseeable problems. *Id.* Notwithstanding that determination, the president of the Exchange corresponded with an official of the United States Department of Agriculture, seeking his opinion on the problem with the Maine potatoes. *Id.* This official informed the NYME president

through January and February of 1979, the NYME concluded that the substandard November deliveries were not indications of serious danger, and that there was a sufficient supply of potatoes for the spring deliveries.<sup>17</sup> In the first week of March, however, twenty-nine of thirty-two loads of potatoes failed inspection at Hunts Point, prompting an emergency suspension of potatoes futures trading by the NYME.<sup>18</sup> Sam Wong & Son, Inc. (Wong), a potato grower who held short positions<sup>19</sup> in the 1979 contracts, sued the NYME, alleging that the NYME should have acted more decisively when the problem first appeared, and should have amended the terms of the potato contract to create a better hedging device.<sup>20</sup> However, Anthony Spinale, a speculator in potato futures, noted that voting board members of the NYME were interested in the outcome of the situation, and asserted that their drastic emergency action prevented him from gaining additional

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that a high percentage of the Maine potato crop of the year was marginally defective but assured the president that the Department of Agriculture would, if necessary, act to prevent a recurrence of the problem. *Id.*

<sup>17</sup> *Id.* The Exchange, at its regular February meeting, focused its attention on the discrepancies between the Maine and New York inspections, and gave little attention to the quality of the year's potato crop. *Id.* In fact, the Exchange's field representative in Maine and its monitoring staff in New York both reported "that there was a sufficient deliverable supply of potatoes." *Id.* However, the CFTC Chief of Market Surveillance maintained that the November 1978 deliveries foreshadowed later problems with the spring deliveries. *Id.* at 658 n.7. He reported that by November rumors were beginning to spread in the potato industry that the crop might be defective because of a dry season. *Id.* at 658 n.7.

<sup>18</sup> *Id.* at 658-61 (quoting from the Report of the Division of Trading and Markets, Commodity Futures Trading Commission (Feb. 1, 1980) [hereinafter cited as Report]). The March deliveries failed inspection because the potatoes were "sunken and discolored," the same problem that plagued the November deliveries. *Id.* at 658 (quoting the Report, *supra*). In the week after the delivery failures, prices for the April and May contracts rose precipitously in trading on the Exchange. *Id.* at 658-659 (quoting the Report, *supra*). The NYME, after speaking to traders, officials of the Maine potato industry, and Department of Agriculture officials, finally concluded that the true problem was with the quality of the crop, not with inspection inconsistencies, as had been previously considered. *Id.* at 659. In an all-night emergency meeting on March 8-9, 1979, The Board of the Exchange declared that an emergency situation existed, and to protect the market from further deterioration, the Board suspended trading in the April and May contracts. *Id.* at 660-61. Furthermore, the Board provided for the liquidation of any unfulfilled March contracts, at a price to be determined by the Exchange. *Id.* at 661.

<sup>19</sup> See *supra* note 2.

<sup>20</sup> 735 F.2d at 656-57. Wong's action was similar to a lawsuit against the NYME in 1976, in which price manipulation by certain traders had led to widescale potato price fluctuations. *Id.* at 657 n.3; see *Leist v. Simplot*, 638 F.2d 283 (2d Cir. 1980), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982). In *Leist*, the injured traders alleged that Exchange officials "knew or should have known" of the emergency situation, but failed to take proper action. 638 F.2d at 292.

profits.<sup>21</sup> The district court dismissed Wong's claim because it did not adequately allege that the Exchange had acted in bad faith.<sup>22</sup> In addition, the court granted summary judgment for the NYME against Spinale, stating that he failed to raise genuine issues of fact concerning bad faith on the part of the Exchange.<sup>23</sup>

A unanimous Second Circuit panel affirmed the decision of the district court with regard to Wong,<sup>24</sup> but reversed the summary judgment granted against Spinale.<sup>25</sup> Writing for the court, Judge Friendly determined that bad faith must be the standard of liability in a lawsuit against an exchange based on action taken by that exchange.<sup>26</sup> Accordingly, the court maintained that the standard of liability for the failure of an exchange to take discretionary action

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<sup>21</sup> 735 F.2d at 657, 672-73. Spinale claimed that the emergency actions were motivated partly by the personal animosity of certain Board members towards him, and partly because certain Board members had financial interests in potato futures contracts. *Id.* at 672-73. Additionally, Spinale alleged that the actions were so negligent as to constitute bad faith. *Id.* at 672.

<sup>22</sup> *Jordon v. New York Mercantile Exch.*, 571 F. Supp. 1530, 1541-42 (S.D.N.Y. 1983), *aff'd in part, rev'd in part, sub nom., Sam Wong & Son, Inc. v. New York Mercantile Exchange*, 735 F.2d 653 (2d Cir. 1984). In *Jordon*, Judge Sofaer ruled, *inter alia*, that a complaint alleging inadequate regulation by an exchange must also allege bad faith on the part of the exchange as a basis for its action or inaction. *Id.* at 1542.

<sup>23</sup> *Id.* at 1544. The district court rejected Spinale's claim that the board acted with self-interest and bad faith, and held that exchange self-regulation mandated that some members of an exchange would have a degree of self-interest in exchange actions. *Id.* at 1544-45. The court stated that to allow a lawsuit based on vague allegations of bad faith would undermine the exchange self regulation concept. *Id.* at 1545. In addition, the court noted that Spinale, as a long trader, had been in a position to reap substantial benefits because of the delivery failures and subsequent price inflation, but had refused to compromise his position or allow his contracts to be liquidated, insisting on delivery. *Id.* at 1551. The court held further that any personal animosity between the board members and Spinale arose in connection with Spinale's dealings. *Id.* As a result, the animosity was within the context of the board's self-regulatory duties, and could not support a determination of bad faith on the part of the Exchange. *Id.* The court also implied that the board was justified in its animosity toward Spinale, since one of its duties was to prevent traders from acting with excessive greed in a time of crisis. *Id.* at 1552.

<sup>24</sup> See 735 F.2d at 666-71. Refusing to recognize a private cause of action alleging a failure by an exchange to amend its contracts, the *Wong* court held that Congress did not intend to create such a right, and that such a provision would be completely unworkable. *Id.* at 669-70. The complaint alleging failure by the exchange to act promptly also failed. See *id.* at 670-71. The court, while not completely ruling out a cause of action for the failure of an exchange to take emergency action, did not decide the question, since Wong's complaint failed to allege bad faith, as required for suits against an exchange. *Id.* at 670; see *supra* note 22 and accompanying text.

<sup>25</sup> 735 F.2d at 678.

<sup>26</sup> *Id.* at 670. (citing *Daniel v. Board of Trade*, 164 F.2d 815, 820 (7th Cir. 1947)). In *Daniel*, the bad faith standard for suits against an exchange was established with respect to actions taken by the exchange. 735 F.2d at 670.

could not reasonably be less than bad faith.<sup>27</sup> Recognizing that the Exchange promptly investigated the delivery problems, the court reasoned that the failure of the Exchange to realize the magnitude of the problem did not constitute bad faith, and thus Wong's complaint lacked an essential element.<sup>28</sup> The court of appeals disagreed with the district court regarding Spinale's complaint, however, deciding that it was a question of fact whether the personal animosity of members of the Exchange toward Spinale, or their possible financial interests in the Exchange's decision, motivated the emergency actions of the Exchange.<sup>29</sup> Judge Friendly determined that Spinale would have the initial burden of showing that personal animosity or financial interests were "a substantial or motivating factor" behind the action or inaction of the Exchange.<sup>30</sup> The court stated that, should Spinale meet this burden, the Ex-

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<sup>27</sup> 735 F.2d at 670. The court took notice of 7 U.S.C. § 25(b)(4)(d) (1982), which, although only applicable to cases accruing subsequent to January 11, 1983, makes bad faith the standard of liability, whether or not any action was taken by an exchange. *See* 735 F.2d at 670.

<sup>28</sup> 735 F.2d at 671. The *Wong* court also affirmed the dismissal of that part of the complaint that alleged a conspiracy of unnamed corporations and individuals to increase and manipulate prices in the potato futures market, finding that there were no allegations of actual or constructive knowledge by the defendants of any conspiracy. *Id.* The court also noted that, although the Exchange might be criticized for not launching a more thorough investigation when the delivery problem first arose, such an oversight was not actionable absent an allegation of bad faith. *Id.*

<sup>29</sup> *Id.* at 678. The court noted that the motives of the Board members in taking emergency actions were at issue, and could not easily be determined on a motion for summary judgment. *Id.* Disagreeing with the determination of the district court, Judge Friendly noted that although Spinale's business conduct may have been distasteful to the board members, Spinale was simply capitalizing on his business acumen, and evidence of animosity by the board members toward Spinale arising from business dealings could support a finding of bad faith. *See id.* The court concluded that Spinale was entitled to limited discovery to ascertain the financial interests of the defendants in the matter, the discussions and occurrences at the board's emergency meeting, and the rationality of the board's emergency actions. *Id.* & n.32. The court recognized that, although contract market officials have broad discretion in regulating their exchanges, the concept of exchange self-regulation requires the court to provide a test that does not give such officials immunity "from answering serious questions posed by injured traders." *Id.* at 677. If exchange officials were never required to answer for their actions, Judge Friendly warned, the private right of action under the CEA would be virtually eradicated. *Id.*

<sup>30</sup> *See id.* at 677. The test applied by Judge Friendly was adopted from a similar standard applied by the Supreme Court in cases involving discriminatory discharges of pro-union employees. *Compare Sam Wong*, 735 F.2d at 667 with *NLRB v. Transportation Management Corp.*, 462 U.S. 393, 403 (1983) (employee had burden of persuading NLRB that employee would have been fired regardless of union activities) and *Mount Healthy City Bd. of Educ. v. Doyle*, 429 U.S. 274, 287 (1977) (once discharged employee met his burden, burden shifted to employer to show that employer not motivated to punish employee).



change could still avoid liability by proving that its action or inaction was in the public interest and would have occurred regardless of any personal animosity or financial concerns of members of the Exchange.<sup>31</sup>

The *Sam Wong* decisions represent an attempt by the Second Circuit to establish parameters for the private cause of action created by the Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,<sup>32</sup> and presently set forth in the Commodity Exchange Act.<sup>33</sup> It is submitted, however, that the Second Circuit unduly restricted the availability of the private cause of action for injured commodities traders by its strict adherence to the bad faith requirement. In light of the importance of the private cause of action in the scheme of commodities market self-regulation under the CEA, it is suggested that redress should be made available to those who are victims of reckless activity by contract markets, as well as to those who may fall prey to the improper motives of exchange board members. This Comment will explore the private cause of action and will attempt to demonstrate that a recklessness standard is needed to provide a remedy for injured commodities traders who are not currently protected by the industry's system of self-regulation.

#### THE PRIVATE CAUSE OF ACTION AND EXCHANGE SELF-REGULATION

To combat the threat of destructive price fluctuations which may be caused by price manipulation and other price abuses by commodities traders, the United States relies heavily on exchange

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<sup>31</sup> 735 F.2d at 677.

<sup>32</sup> 456 U.S. 353 (1982); see *supra* note 9 and accompanying text.

<sup>33</sup> See 7 U.S.C. § 25(a) (1982). In 1982 Congress expressly amended the CEA to include the private right of action that had been created by judicial decisions throughout the country, culminating with the decision in *Curran*. See Sackheim, *supra* note 1, at 71. Prior to 1982, the federal courts had disagreed as to the existence of an implied private right of action under the CEA. Compare *Moody v. Bache & Co.*, 570 F.2d 523, 527 (5th Cir. 1978) (private action under CEA would lie, but plaintiff failed to prove causation) and *Jones v. B.C. Christopher & Co.*, 466 F. Supp. 213, 221 (D. Kan. 1979) ("private right of action may be implied under . . . Act") with *Berman v. Bache, Halsey, Stuart, Shields, Inc.*, 467 F. Supp. 311, 321 (S.D. Ohio 1979) (no section of Act grants jurisdiction with respect to private parties) and *Fischer v. Rosenthal & Co.*, 481 F. Supp. 53, 55 (N.D. Tex. 1979) (no private right of action can be implied under CEA).

The private cause of action provision was added by the Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294, 2322-24 (1983). Although 7 U.S.C. § 25 technically did not govern the *Sam Wong* case, the Court made reference to its provisions. See 735 F.2d at 665-66.

self-regulation.<sup>34</sup> Charged with the responsibility of protecting the integrity of commodities trading, contract markets are required to promulgate and enforce their own rules<sup>35</sup> and must maintain constant surveillance of market activity to detect situations that might lead to price distortions.<sup>36</sup> If an exchange fails to regulate its members, it faces suspension or revocation of its designation as a contract market<sup>37</sup> and may be subject to liability in private actions brought by injured traders.<sup>38</sup>

The private cause of action under the CEA is a relatively recent development.<sup>39</sup> For the first thirty years following the enactment of the CEA in 1936, traders were required to settle their grievances through arbitration and mediation mechanisms provided by the exchanges.<sup>40</sup> In the early 1960's, however, many traders became dissatisfied with private settlements of their complaints and sought relief in federal court for violations of the CEA.<sup>41</sup>

In 1967, the private cause of action for a violation of the CEA was recognized for the first time in *Goodman v. H. Hentz & Co.*<sup>42</sup> In *Goodman*, a group of plaintiffs brought a class action against the defendant broker, alleging violations of the Commodity Ex-

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<sup>34</sup> See S. REP. NO. 1131, 93d Cong., 2d Sess. 1, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5843, 5855-56; Note, *Abuses in the Commodity Markets: The Need for Change in the Regulatory Structure*, 63 GEO. L.J. 751, 761 (1975). The Commodity Exchange Act is targeted at abuses such as price manipulation, excessive speculation, and various fraudulent and fictitious transactions that tend to impair commodities trading. See S. REP. NO. 1131, 93d Cong., 2d Sess. 13, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 5843, 5856. In addition to preventing these abuses, the exchanges must establish trading limits to prevent "sudden or unreasonable" price fluctuations. See 7 U.S.C. § 69 (1982); Note, *supra*, at 761.

<sup>35</sup> See 7 U.S.C. § 7a (1)(8)(9) (1982). Contract market rules must be previously approved by the CFTC. *Id.*

<sup>36</sup> See 17 C.F.R. § 1.51 (a)(1) (1984). Among other things, Contract markets must monitor price movements, volume of trading in the market, market news and gossip. See Contract Market Rule Enforcement Program, Guideline No. 2, 1 COMM. FUT. L. REP. (CCH) ¶ 6430 (1982).

<sup>37</sup> See 7 U.S.C. §§ 7, 8 (1982).

<sup>38</sup> See *supra* note 33 and accompanying text.

<sup>39</sup> See Note, *Private Rights of Action Under the Commodity Futures Trading Commission Act of 1974: The Curran Decision*, 61 WASH. U.L.Q. 561, 565-66; see also *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 443 (N.D. Ill. 1967) (existence of civil remedy under CEA had never previously been determined). Courts previously had entertained lawsuits against exchanges for allegations of fraud and antitrust violations, but these lawsuits were not implied from provisions of the CEA. See, e.g., *Daniel v. Board of Trade*, 164 F.2d 815, 820 (7th Cir. 1947) (fraud); *Cargill v. Board of Trade*, 164 F.2d 820, 823 (7th Cir. 1947) (antitrust), *cert. denied*, 333 U.S. 880 (1948).

<sup>40</sup> See Note, *supra* note 39, at 565 & n.31.

<sup>41</sup> See *id.* at 565-66.

<sup>42</sup> 265 F. Supp. 440, 447 (N.D. Ill. 1967).

change Act, and the court held that the plaintiffs had stated a valid cause of action.<sup>43</sup> While stating that no civil remedy had been expressly created by the CEA, the court held that the statute created a private cause of action by meeting a two part test: the statute was intended to protect the interests of individuals such as the plaintiffs; and the interest invaded by the defendants was one that the enactment was intended to protect.<sup>44</sup>

The *Goodman* rationale was adopted by a number of courts in cases involving broker fraud<sup>45</sup> and in cases involving allegations that an exchange failed to enforce its rules.<sup>46</sup> By 1974, most federal courts routinely and consistently recognized an implied private cause of action under the CEA.<sup>47</sup> In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*,<sup>48</sup> the Supreme Court eliminated any doubt regarding the existence of an implied private cause of action.<sup>49</sup> The Court gave its imprimatur to the private action, saying

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<sup>43</sup> *Id.* at 442, 446-47. The plaintiffs in *Goodman*, customers of the defendant broker, alleged that the defendant's agent had defrauded them and had made several false statements in a number of commodities transactions, in violation of 7 U.S.C. § 6(b) (1982). *See* 265 F. Supp. at 442, 447.

<sup>44</sup> *See* 265 F. Supp. at 447. The *Goodman* court noted that private causes of action had been recognized for certain violations of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). *See* 265 F. Supp. at 447.

<sup>45</sup> *See, e.g.*, *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 133 (8th Cir. 1970) (allegedly excessive trading of account by broker); *Arnold v. Bache & Co.*, 377 F. Supp. 61, 65 (M.D. Pa. 1973) (allegations of false representations by broker); *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764, 766 (S.D.N.Y. 1972) (allegation of "churning" by broker, i.e., excessive trading to generate commissions).

<sup>46</sup> *See, e.g.*, *Case & Co. v. Board of Trade*, 523 F.2d 355, 360-61 (7th Cir. 1975) (failure to give required notice of suspension of trading limits); *Deaktor v. L.D. Schreiber & Co.*, 479 F.2d 529, 530, 534 (7th Cir.) (failure of exchange to present unlawful manipulation by certain traders on exchange), *rev'd on other grounds sub nom.*, *Chicago Mercantile Exch. v. Deaktor*, 414 U.S. 113 (1973); *Seligson v. New York Produce Exch.*, 378 F. Supp. 1076, 1084 (S.D.N.Y. 1974) (failure by exchange to maintain orderly market), *aff'd sub nom.*, *Miller v. New York Produce Exch.*, 550 F.2d 762 (2d Cir. 1977).

<sup>47</sup> *See, e.g.*, *Rivers v. Rosenthal & Co.*, 634 F.2d 774, 779 (5th Cir. 1980) (all courts unanimously allowed private cause of action under CEA before 1974), *vacated for further consideration*, 456 U.S. 968 (1982); *see also* Davis, *The Commodity Exchange Act: Statutory Scheme is Not Authorization of an Implied Private Cause of Action*, 46 Mo. L. REV. 316, 321 (1981) (prior to 1974 federal courts routinely assumed private causes of action under CEA).

<sup>48</sup> 456 U.S. 353 (1982).

<sup>49</sup> *Id.* at 381. In 1974, amendments to the CEA created some doubt whether private causes of action were authorized. *See* Commodities Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389, 1389-95 (codified as amended in scattered sections of 7 U.S.C. (1982)). *Inter alia*, the amendments were designed to prevent contract markets from attempting to limit their exposure to liability by eliminating certain rules. *See* Note, *supra* note 39, at 567. The rationale behind these actions seemed to be that the less rules an

that it had "enhance[d] the enforcement mechanism fostered by Congress over the course of 60 years."<sup>50</sup>

It is submitted that, in light of the significant role the private cause of action plays in the system of regulation under the CEA, its availability should not be limited to those plaintiffs who can demonstrate improper motives on the part of a defendant. The restrictive interpretation of "bad faith" applied in *Sam Wong*,<sup>51</sup> it is submitted, drastically curtailed the utility of the private cause of action as a means of protecting commodities traders. It is suggested that, if the private cause of action is also made available to those plaintiffs who can demonstrate that a contract market acted in a reckless manner, the regulation of futures trading would be strengthened, and the legislative purpose of the CEA would be

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exchange had the lower the chance of a lawsuit based upon the non-enforcement of those rules. See *id.* at 567 n.40. The 1974 amendments to the CEA did not expressly mention private lawsuits, leaving some courts to maintain that Congress has implicitly eliminated them. See, e.g., *Rivers v. Rosenthal & Co.*, 634 F.2d 774, 781 (5th Cir. 1980) (implied judicial private right of action was not included in 1974 revision of CEA), *vacated for further consideration*, 456 U.S. 968 (1982); *Paine Webber, Jackson & Curtis, Inc. v. Conaway*, 515 F. Supp. 202, 209-10 (N.D. Ala. 1981) (private judicial right of action did not survive 1974 Amendments); *Walsh v. International Precious Metals Corp.*, 510 F. Supp. 867, 871 (D. Utah 1981) ("1974 amendments to CEA extinguished any private right of action previously available"). But see *Leist v. Simplot*, 638 F. 2d 283, 307 (2d Cir. 1980) (legislative history amply demonstrates Congress' awareness of private right of action under CEA, and desire to preserve it), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); *Smith v. Groover*, 468 F. Supp. 105, 115 (N.D. Ill. 1979) (private right of action is consistent with statutory purpose of CFTCA); *Hofmayer v. Dean Witter & Co.*, 459 F. Supp. 733, 737-38 (N.D. Cal. 1978) (legislative history precludes finding that Congress intended to overrule judicially created private action under CEA).

In *Merrill Lynch*, the Court relied upon criteria established in *Cort v. Ash*, 422 U.S. 66 (1975), focusing on the intent of Congress in enacting the 1974 amendments, see 456 U.S. at 377-78. The Court concluded that the implied cause of action under the CEA was "part of the 'contemporary legal context' in which Congress legislated in 1974." *Id.* at 381 (quoting *Cannon v. University of Chicago*, 441 U.S. 677, 699 (1979)). The Court reasoned that, because Congress did not change the statutory provisions under which the cause of action had been implied, it was apparent that "Congress affirmatively intended to preserve that remedy." 456 U.S. at 381-82.

<sup>50</sup> 456 U.S. at 387.

<sup>51</sup> See 735 F.2d at 670; *supra* notes 26-31 and accompanying text. Wong maintained that the exchange had violated 7 U.S.C. § 7a(8) (1982), which requires contract markets to enforce all bylaws, rules, and regulations of the CFTC, by failing to monitor the market for possibly disruptive situations, as mandated by CFTC Regulation 1.51(a)(2), 17 C.F.R. § 1.51(a)(2) (1984). See 735 F.2d at 670. The court in *Wong* required that a private cause of action allege affirmative bad faith, as evidenced by the exchange's knowledge of some fraudulent activities or by ulterior motives on the part of exchange members as a basis for their failure to act. See *id.* at 670-71. It is submitted that the court did not consider a "reckless bad faith" standard—liability predicated upon proof that the exchange acted recklessly in failing to monitor closely the market situation and discover the potential delivery problems.

furthered.<sup>52</sup>

### "RECKLESS BAD FAITH" AS A STANDARD FOR EXCHANGE LIABILITY

"Bad faith" can be described as a state of mind operating with furtive design or ill will.<sup>53</sup> "Scienter," as a requirement for securities fraud lawsuits, has been defined as "intent to deceive, manipulate, or defraud."<sup>54</sup> Numerous cases have held that reckless conduct<sup>55</sup> can constitute scienter or bad faith in lawsuits involving fraudulent commodities<sup>56</sup> and securities transactions.<sup>57</sup>

<sup>52</sup> See *supra* note 1; see also H.R. REP. NO. 93-975, 93d Cong., 2d Sess. 34 (1974) (public interest requires that contract markets operate under close scrutiny so that they best serve legitimate market functions).

<sup>53</sup> See *Vickers v. Motte*, 109 Ga. App. 615, 617, 137 S.E.2d 77, 80 (1964); *Stath v. Williams*, 367 N.E.2d 1120, 1124 (Ind. App. 1977).

<sup>54</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

<sup>55</sup> See W. PROSSER & W. KEETON, *THE LAW OF TORTS* 213 (5th ed. 1984) (to act "recklessly" is to act in disregard of obvious risk). Liability for recklessness is based on constructive knowledge—i.e., the actor is presumed to have been aware of an obvious risk. *Id.* The Court of Appeals for the Sixth Circuit has defined recklessness as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979). Reckless behavior is more closely related to intentional conduct than to negligence. See *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977).

<sup>56</sup> See, e.g., *First Commodity Corp. v. CFTC*, 676 F.2d 1, 6-7 (1st Cir. 1982) (CFTC can base liability for broker fraud on recklessness); *CFTC v. Savage*, 611 F.2d 270, 283 (9th Cir. 1979) (knowledge, for purposes of fraudulent intent, exists when one acts in careless disregard of whether his acts amount to fraud); *Silverman v. CFTC*, 549 F.2d 28, 31 (7th Cir. 1977) (willfulness includes actions done in "careless disregard of statutory requirements") (quoting *Goodman v. Benson*, 286 F.2d 896, 900 (7th Cir. 1961)).

<sup>57</sup> See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979) (majority of courts have concluded that recklessness satisfies scienter requirement for securities fraud); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978) (recklessness, defined as "carelessness approaching indifference," can serve as ground for securities fraud action); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir.) (recklessness can constitute scienter in "appropriate circumstance"), *cert. denied*, 439 U.S. 1039 (1978). Brokerage firms have been held liable for securities fraud in cases in which it has been determined that they acted in reckless disregard for their client's interests. See, e.g., *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 775 (9th Cir. 1984) (excessive trading on client's account); *Kehr v. Smith Barney, Harris Upham & Co.*, 736 F.2d 1283, 1286 (9th Cir. 1984) (failure to advise client of risks of transactions).

It has been noted that securities and commodities trading have many similarities, and that section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1982), has significantly influenced commodities law. See 1 A. BROMBERG & L. LOWENFELS, *supra* note 2, at § 1.1; see also *CFTC v. J.S. Love & Assocs. Options, Ltd.*, 422 F. Supp. 652, 660-61 (S.D.N.Y. 1976) (there are similarities and analogies between securities and commodities antifraud provisions); Johnson, *Applying Hochfelder in Commodity Fraud Cases*, 20 B.C.L. REV. 633, 633 (1979) (§ 4b of the CEA, 7 U.S.C. § 6b (1982), analogized to § 10b of Securities Exchange Act, 15 U.S.C. § 78j(b) (1982)). It is submitted that the "reckless bad faith" standard, as adopted from both securities and commodities fraud cases, is an appropriate standard for

A number of cases involving contract market liability for failure to act in emergency situations have made reference to a form of the reckless bad faith standard.<sup>58</sup> Judge Friendly himself has acknowledged a reckless standard in both securities<sup>59</sup> and commodities fraud cases.<sup>60</sup> In dictum, the district court in *Wong* asserted that "[o]nly a demonstration of reckless and virtually irrational exchange behavior could . . . independently [constitute] . . . bad faith."<sup>61</sup> Judge Friendly, however, declined to adopt such an approach, deciding instead that, for an exchange to be held liable for failure to act, it must know of an impending problem and refuse to act on it.<sup>62</sup>

The reckless bad faith standard, it is suggested, will prove useful in cases in which it would be difficult, if not impossible, to prove the defendant's knowledge of impending emergency situations<sup>63</sup> and would significantly increase the chances of punishing those persons whose conduct is tantamount to fraud.<sup>64</sup>

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imposing liability on an exchange for its failure to take necessary action in emergency situations.

<sup>58</sup> See, e.g., *Leist v. Simplot*, 638 F.2d 283, 292 (2d Cir. 1980) (exchange officials "knew or should have known" of emergency situation), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); *Smith v. Groover*, 468 F. Supp. 105, 118 (N.D. Ill. 1979) (private action is available against exchanges that knew or should have known of fraudulent conduct by their members). One of the claims upheld in *Curran* was that the NYME "knew or should have known" of alleged conspiracies to manipulate the contract market, but failed to prevent them. See *Curran*, 456 U.S. at 371; see also *Gordon v. Hunt*, 558 F. Supp. 122, 124 (S.D.N.Y. 1983) (dictum) (*Curran* may authorize lawsuits against exchange on less restrictive bases than traditional bad faith).

<sup>59</sup> See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring) (liability can be imposed for "the type of recklessness that is equivalent to willful fraud"), *cert. denied sub nom.* 394 U.S. 976 (1969).

<sup>60</sup> See *Leist v. Simplot*, 638 F.2d 283, 292 (2d Cir. 1980) (Friendly, J.), *aff'd sub nom.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982); *supra* note 58.

<sup>61</sup> See *Jordon v. New York Mercantile Exch.*, 571 F. Supp. 1530, 1552 (S.D.N.Y. 1983) (dictum), *aff'd in part, rev'd in part sub nom.*, *Sam Wong & Son, Inc. v. New York Mercantile Exch.*, 735 F.2d 653 (2d Cir. 1984).

<sup>62</sup> See *Sam Wong*, 735 F.2d at 671. Judge Friendly determined that Wong's allegations concerning the failure of the exchange to act did not meet the bad faith standard: that is, knowledge of an impending crisis, or some ulterior motive in failing to act. *Id.* But cf. *CFTC v. Savage*, 611 F.2d 270, 283 (9th Cir. 1979) (knowledge cannot be precluded by ignorance brought about by carelessly ignoring truth). While it is not maintained that the New York Mercantile Exchange ignored the truth, it is submitted that Judge Friendly's requirement of knowledge is too stringent for the purposes of exchange liability.

<sup>63</sup> Cf. *Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delecto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597, 635-36 (1972) (often court will not have direct evidence regarding knowledge, based on circumstances). Knowledge, in effect, can be shown by reckless conduct. *Id.* at 638.

<sup>64</sup> See *Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5*,

## CONCLUSION

By failing to adopt a reckless bad faith standard for exchange liability, the Court of Appeals for the Second Circuit has strictly limited actions against an exchange. Under the test applied by Judge Friendly to the action brought by Spinale, only a plaintiff who alleges a conflict of interest or ulterior motive on the part of an exchange will be given an opportunity to develop his theory. The strict bad faith requirement set down in *Sam Wong* will insulate exchanges from liability for decisions that may have been reckless, and may even encourage plaintiffs to make allegations of bad faith that have no basis in fact to avoid dismissal. Whether price fluctuations and instability are caused by fraudulent or reckless decisions by an exchange is immaterial; the harmful effect on futures trading is the same, and lawsuits involving either of these allegations deserve equal treatment.

*Joseph M. Barry*